Chapter One

The Economic Outlook

The pickup in economic activity, which has been under way since the spring of 1991, will continue, according to the economic forecast of the Congressional Budget Office (CBO). On a fourth-quarter-to-fourth-quarter basis, real growth will average about 2.5 percent in 1993 and 1994, somewhat slower than last year's 3.1 percent growth but faster than the potential of the economy to expand in the long run. Inflation will average about 3.2 percent for 1993 and 1994, negligibly higher than the 3.1 percent rate of 1992. The unemployment rate is likely to fall only slowly.

Although growth and inflation have been erratic in the last few quarters, recent developments suggest that the economy has moved beyond an important transition point. In particular, the growth in employment, which was extremely weak for almost two years after the recession's official end in March 1991, has finally posted some respectable gains. The economy now appears to be headed for a broader phase of expansion during which consumption and investment in business equipment will sustain growth.

Although this transition marks the consolidation of the expansion, it does not portend any quickening of growth: major uncertainties about the outlook stubbornly remain. Notable downside risks include the degree to which slow growth overseas will weaken U.S. exports, how much consumer spending will fall in response to the tax increase enacted as part of the 1993 deficit reduction package, and how further corporate restructuring will affect jobs. Conversely, the recent gains in employment, lower interest rates, and the strong competitive position of many U.S. companies may spark faster growth.

Tighter fiscal policy and somewhat worse prospects for growth abroad have reshaped CBO's outlook since its January report. Actions by the federal government to reduce the deficit will restrain growth somewhat for the balance of 1993 and through 1994. The slowdowns in the Japanese and European economies will also hold down growth of output in the United States through 1994.

Eventually, however, the fiscal policy of the federal government will promote a higher potential growth rate for the economy. Federal deficits and borrowing will be lower than previously projected, precipitating a boost in national saving. In turn, more saving will increase levels of private domestic investment, labor productivity, and incomes.

CBO's Economic Forecast for 1993 Through 1994

CBO forecasts that real gross domestic product (GDP) will grow at a rate of about 3 percent in the last half of 1993. However, because of the disappointing growth already recorded in the first half, growth will average only 2.3 percent over the four quarters of 1993, and 2.7 percent over the four quarters of 1994 (see Table 1-1 and Figure 1-1). The forecast for growth for 1994 is slightly lower than the rate of 3 percent that was forecast last winter,

Table 1-1.
The CBO Forecast for 1993 and 1994

	1992[a]	Forecast 1993	Forecast 1994
	Fourth Quarter to Fourth Quarter (Percentage change)		
Nominal GDP			
CBO summer	5.7	5.2	5.2
CBO winter	5.1	5.4	5.4
Real GDP[b]			
CBO summer	3.1	2.3	2.7
CBO winter	2.7	2.8	3.0
Implicit GDP Deflator			
CBO summer	2.5	2.8	2.5
CBO winter	2.4	2.5	2.4
Consumer Price Index[c]			
CBO summer	3.1	3.4	3.1
CBO winter	3.1	2.8	2.7
	Calendar Year Averages (Percent)		
Real GDP[b]			
CBO summer	2.1	2.6	2.7
CBO winter	2.0	2.8	3.0
Civilian Unemployment Rate			
CBO summer	7.4	6.9	6.6
CBO winter	7.4	7.1	6.6
Three-Month Treasury Bill Rate			
CBO summer	3.4	3.1	3.6
CBO winter	3.5	3.1	3.7
Ten-Year Treasury Note Rate			
CBO summer	7.0	6.0	6.1
CBO winter	7.0	6.7	6.6

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

NOTE: The data in the table do not incorporate either the advance estimate of second-quarter GDP released by the Bureau of Economic Analysis in late July or the effects of the regular annual revision to the national income and product accounts released by BEA in late August.

a. The data for 1992 are actual values for the summer forecast but are estimates for the winter forecast.

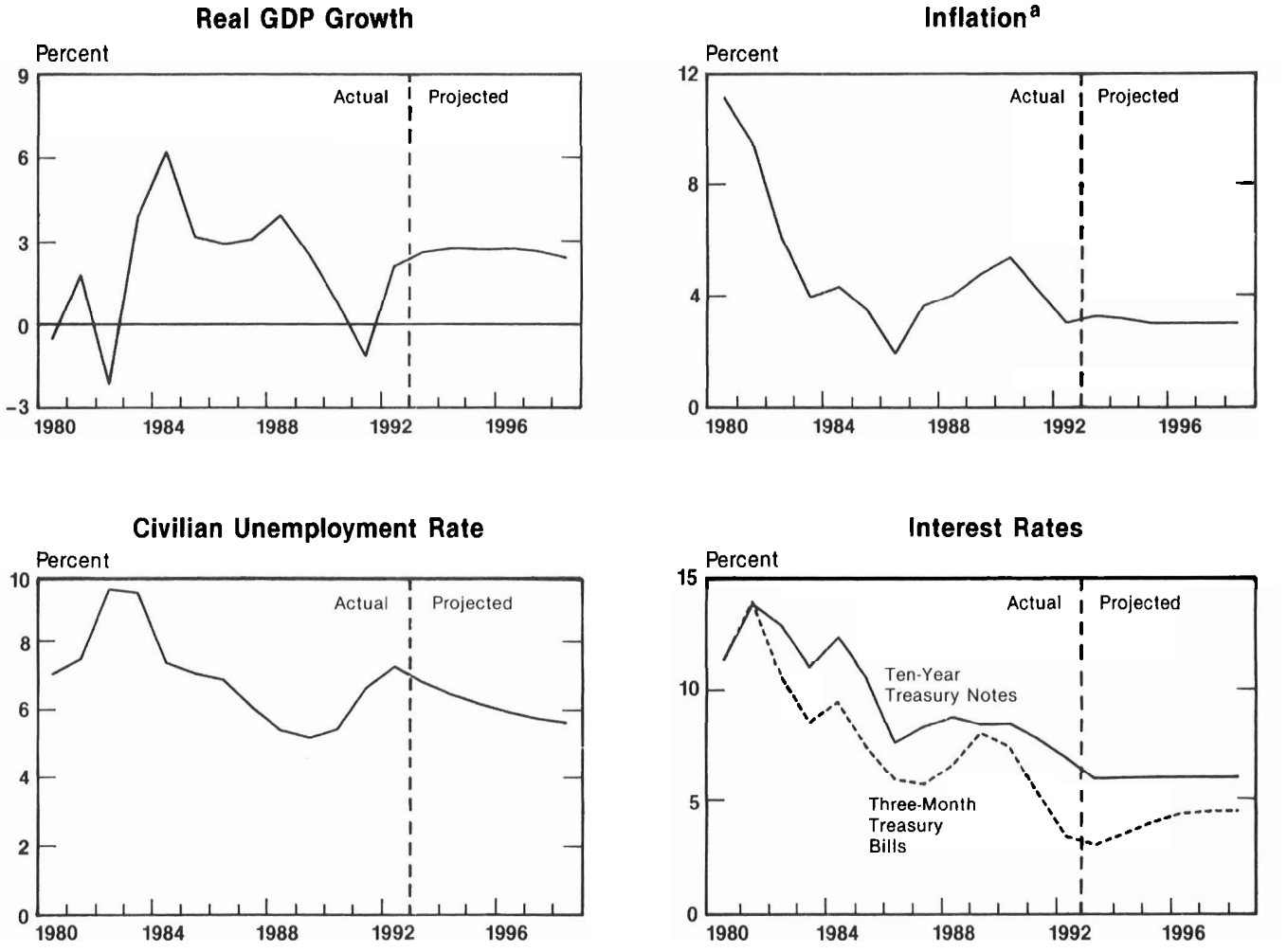
b. Based on constant 1987 dollars.

c. The consumer price index for all urban consumers (CPI-U).

primarily because both the effort to control the deficit and the lower-than-expected growth abroad are likely to restrain the economy. That restraint is partially offset, however, by long-term interest rates that have already dipped lower than forecast last winter.

The rate of unemployment will fall only gradually, from an average of 6.9 percent in 1993 to 6.6 percent in 1994, the same rate for 1994 that CBO forecast last winter. With the gap between potential and actual GDP still significant during 1994, inflation will ease slightly from 3.4 percent in 1993 to 3.1 percent in 1994, as measured by the fourth-quarter-to-fourth-quarter percentage change in the consumer price index for all urban consumers (CPI-U). This forecast for inflation is slightly higher than last winter's forecast.

Figure 1-1.
The Economic Forecast and Projection



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Federal Reserve Board.

NOTE: All data are annual values; growth rates are year over year.

a. Consumer price index for all urban consumers (CPI-U). The treatment of home ownership in the official CPI-U changes in 1983. The inflation series in the figure uses a consistent definition throughout.

Short-term rates of interest (represented by the rate on three-month Treasury bills) are forecast to rise from an average of 3.1 percent in 1993 to 3.6 percent in 1994, virtually the same as CBO forecast last winter. CBO's forecast for long-term interest rates, by contrast, is significantly below last winter's. Long-term interest rates (measured by the rate on 10-year Treasury notes) are expected to hover relatively close to current levels, averaging 6 percent in 1993 and 6.1 percent in 1994. Continued moderate inflation will help to reduce the inflation premium in long-term rates and keep them from rising. Together, the forecasts for interest rates narrow the unusually large spread between long-term and short-term interest rates that has characterized the last two to three years.

Business and consumer spending are expected to propel real GDP from mid-1993 through 1994. Long-term interest rates are considerably lower than last year, corporate cash flow is healthy, and businesses are still striving to meet competition from abroad. These factors should sustain the strong growth of expenditures on durable equipment in the business sector. Although spending on structures by businesses is not expected to contribute to growth this year, the two-and-one-half-year decline in such spending may end later this year or early next year, followed by modest growth. Lower long-term rates, which have helped to make houses more affordable, will sustain the growth of residential construction throughout the forecast period. Consumer spending, including spending on durable goods, should benefit from the recent decline in long-term rates. In addition, gradually improving conditions in the labor market should support growth in consumer spending.

In contrast to these sources of strength, spending by government and net export sales will impair growth. The federal government has embarked on a major new effort to bring the deficit under control, state and local governments still face tight budgets, and the outlook for growth abroad has weakened far more than was foreseen.

What Current Trends Indicate

During the first half of the year, economic growth slowed sharply from the 4 percent growth of the last half of 1992 to about 1 percent. Although a number of signs are worrisome--most notably, the continued large layoffs announced by major corporations--the slow growth appears to be temporary. Some of the slowdown of the first half stemmed from clearly temporary events, and indications are that growth will pick up in the second half of this year. Gains in employment have firmed up, which along with expanded production of motor vehicles is expected to boost the economy during the second half of 1993.

Although some measures of inflation jumped in the first four months of this year, the underlying rate of inflation barely moved at all. Temporary factors spurred the jump, and inflation subsided by midyear. In contrast, the underlying rate of inflation remained steady at just under 3½ percent in the first seven months of 1993, about the same rate as 1992.

Temporary Factors and the Recent Pattern of Growth

Three temporary factors accounted for about half of the reduction in growth between the last half of 1992 and the first half of 1993.

- Even before the recent flood and heat wave, unseasonable weather was affecting the quarterly pattern of real growth. Mild weather in the last months of 1992, followed by harsh weather early this year, boosted construction in the fourth quarter of last year and dampened it in the first quarter of this year. The flooding and the heat wave are also expected to have temporary effects on measures of growth during the last half of 1993, but the net effects are expected to be small.

- Real outlays for defense declined sharply in the first quarter of 1993 and remained low in the second quarter.

- The change in tax withholding that the Bush Administration made effective early in 1992 boosted disposable income and consumption in the second half of 1992 at the expense of early 1993. The revised withholding schedules gave consumers more money to spend. However, that apparent boon resulted in smaller refunds or larger tax bills than usual, restraining consumer spending in the first half of this year.

These three factors probably stimulated growth in the last half of 1992 by about three-fourths of a percentage point and dampened growth in the first half of this year by a similar amount. When one corrects for these transitory events, underlying growth was about 3¼ percent in the last half of last year, and about 1¾ percent in the first half of this year--still a slowdown, but much less severe than the unadjusted growth rates indicated.

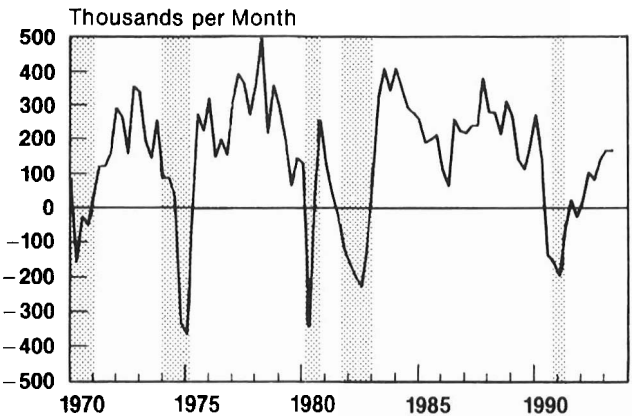
Developments in Labor Markets

Recent gains in employment indicate that the growth of output will pick up during the second half of 1993. The gains during the first six months of this year, a clear improvement over the previous two years, support the view that the economy has achieved a self-sustaining expansion. Such a sustained growth in employment and, correspondingly, in real wages and salaries is needed to support consumption.

The growth in productivity and the rise in hours worked per employee almost certainly accounted for the growth of output during the first two years of the recovery. Only after the recovery had lasted a year did the number of jobs increase at all. As a result of slow growth in employment, the recovery was labeled a "jobless recovery," and many policymakers feared the fledgling expansion would not reach its critical self-sustaining stage.

By contrast, the employment picture improved substantially this year. The number of people employed surpassed the prerecession peak, and growth in employment averaged just under 170,000 jobs per month during the first seven months of the year (see Figure 1-2). Payroll employment climbed at an average annual rate of 1.9 percent in the first seven months of 1993, significantly faster than its 0.9 percent advance in 1992. Excluding some extraordinary bonus payments around the turn of the year, real wage and salary income (which accounts for almost 60 percent of total personal income) has increased correspondingly.

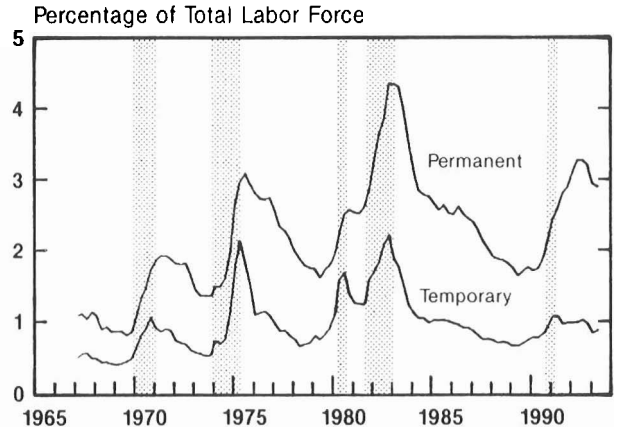
Figure 1-2.
Change in Employment



SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

Nevertheless, some worries about the labor market persist. Although permanent job losses have dropped below their 1992 peak, they remain high, and some prominent firms continue to announce new layoffs (see Figure 1-3). These job losses undoubtedly reflect long-term adjustments of the economy that continue to restrain the growth of output. The defense-related industry is the single largest sector that is being forced to contract, with the bulk of the decline yet to come. Studies have estimated that defense-related jobs fell by be-

Figure 1-3.
Permanent and Temporary Job Losses



SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics.

NOTE: Temporary job losses are those currently unemployed and classified as layoffs; permanent are all other job losses.

tween 0.9 million and 1.1 million over the 1987-1992 period, and they are projected to shrink by between 1.4 million and 1.9 million over the 1993-1997 period.[1] The restructuring process has also been only partly completed in many of the other sectors that have been in turmoil recently. Firms producing consumer products, computers, and other goods and services have continued to announce reductions in work force, reflecting in part an effort by businesses to reduce tiers of middle managers.

The decline in the unemployment rate will be slow. The rate of participation in the labor force--the percentage of the working-age population wanting to work--is likely to rise, and this growth will dampen the decline in the unemployment rate. The participation rate has varied more in recent years than usual. Although the reasons are not clear, participation in the labor force seems to be more closely related to job availability than in the past. It peaked in the fourth quarter of 1989 at 66.7 percent and fell in the recession to under 66 percent during 1991. The drop in participation dampened the increase in the unemployment rate during the recession; conversely, a pickup in participation to 66.4 percent by mid-1992 contributed to a rise in the unemployment rate after the recession. Should this pattern continue, the unemployment rate will decline only slowly.

1. Congressional Budget Office, "Effects of Alternative Defense Budgets on Employment," CBO Paper (April 1993); and Norman C. Saunders, "Employment Effects of the Rise and Fall in Defense Spending," *Monthly Labor Review*, vol. 116, no.4 (April 1993), pp. 3-10.

Other Indications of a Pickup in Growth

The gain in employment and hours worked during the first half of 1993 is probably the most important indication that growth is apt to be stronger in the second half, but other indicators also bode well. The low ratio of inventory to sales--by midyear, equal to about one-half of a month of inventory in manufacturing and trade--means that if the recent solid growth in sales continues it will stimulate production of goods in the second half of 1993. One major sector that could boost output in the second half is the motor vehicle industry. Vehicle assemblies are scheduled to be about 18 percent higher in the third quarter of this year than last, and the strength of motor vehicle sales during the first half of this year indicates that those schedules will be met.

Residential construction should rebound from its weak performance during the first half of the year. After advancing at a rapid 11.9 percent rate in the last half of 1992, residential construction slipped 4.2 percent over the first six months of this year, with weather accounting for some of this decline. Over the past year, however, homes have become more affordable. For example, an index measuring the affordability of housing has risen 11 percent over the past four quarters as a result of lower mortgage rates, improved incomes, and modest changes in housing prices. Given the affordability of houses, the improvement in employment, and the recent uptick in house sales, residential construction will probably be stronger during the second half.

The Underlying Rate of Inflation

As with real growth, temporary factors affected the quarterly pattern of inflation. Between the third quarter of 1992 and the first quarter of this year, consumer price inflation leaped from 2.7 percent to 3.8 percent, only to ease dramatically to 2.9 percent in the second quarter of this year. The low rates during the summer of last year were partially the result of extraordinary events, such as weak food prices and discounts on airline fares.

The inflation spike in the first quarter of this year also stemmed from unusual movements in particular prices rather than from incipient inflationary pressures. Prices in two of the major categories of the consumer price index--apparel and transportation--grew rapidly in the first quarter, but these increases were clearly temporary. Prices for apparel increased at about a 6 percent annual rate, whereas the average growth over the previous year had been 1.5 percent. This price spike resulted from the introduction by retailers of new, higher-priced spring clothing earlier than usual this year. Transportation prices were also temporarily boosted by increases in gasoline prices and public transportation (airline, bus, and railroad) fares.

Similarly, transitory factors prompted the drop to 2.9 percent inflation during the second quarter. The price cut on premium cigarettes, another round of summer airfare reductions, and lower gasoline prices depressed inflation during the second quarter, but some of those price cuts may be reversed in the fall. CBO estimates that the rate of inflation for recent months is about 3¼ percent if temporary factors are excluded.

Fiscal Policy Reshapes the Outlook

Significant changes in fiscal policy since CBO's January forecast and the fall in long-term interest rates near the beginning of the year have reshaped the economic forecast. Although on balance these events will slightly reduce the overall growth of the economy during the 1993-1994 period, the components of final demand will shift significantly from consumption of private-sector nondurable goods to private-sector investment and durable goods. The increase in the investment share of GDP will in turn set the stage for a higher level of potential GDP in the long run.

Under the Omnibus Budget Reconciliation Act of 1993 (OBRA-93), CBO estimates that the deficit excluding deposit insurance will decline from $292 billion in 1993 to $240 billion in 1994 and $206 billion in 1995. After that it remains fairly stable through 1998. Without OBRA-93, the deficit (excluding deposit insurance) would not have declined as much in 1994 and 1995 and would have soared to a record $347 billion by 1998.

Decline in Long-Term Interest Rates Will Buoy Private Demand

The new Administration's announced intention to reduce the deficit early in the year coincided with a significant decline in long-term interest rates. The announcement itself probably played some role in the decline, but other factors may have also contributed.

Lower deficits reduce interest rates by weakening the economy and reducing the federal government's demand for credit. The drop in rates early this year was unusually large, however. Long-term interest rates dropped by about 0.6 percentage points in the first three months of 1993 and have fallen further since then. Although a quick response to the announced program was always a possibility, few economists expected so rapid and steep a drop in rates.

In addition to the President's program, foreign events have worked to lower interest rates. Certainly, an important factor was the troubling news about the economies of Europe and Japan. Because world capital markets are

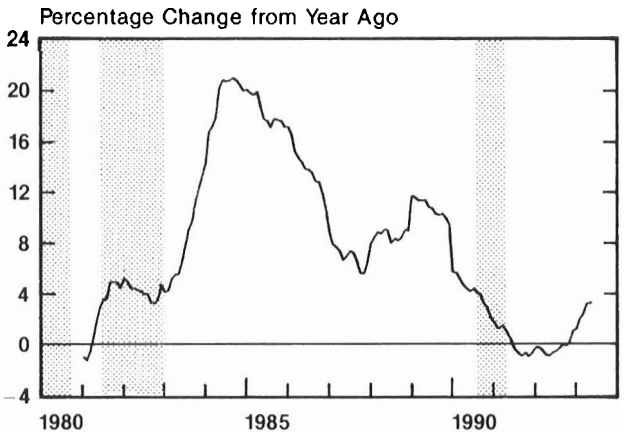
tightly linked, the weakness in those economies probably also contributed to lower U.S. interest rates.

Another factor is a possible market reassessment of future nonfederal demands for capital. For some time, economists have thought that long-term rates were high, given the weakness in the economy and the outlook for inflation. The spread between long- and short-term interest rates was extraordinarily wide during 1992, and long-term interest rates also appeared to be high when adjusted for inflation. Many analysts attributed the high rates in part to fears of a worldwide shortage of capital during the 1990s. The drop in rates this year may be partially related to a delayed reassessment of future demand and supply of capital.

Whatever its cause, the decline in long-term rates improves the outlook for private spending financed with credit. Lower interest rates reduce the cost of borrowing and thereby stimulate private spending. The decline in long-term interest rates in 1993, by itself, makes capital spending by business more attractive. Consumers may spend more on durable goods, such as automobiles and major appliances, and on housing (new homes and repairs and alterations of existing homes). Resumed growth in consumer installment debt suggests that consumers have begun to respond to lower borrowing costs. Consumer installment debt climbed 3.8 percent in June from one year earlier, compared with about 1 percent at the end of 1992 and year-over-year declines stretching from the middle of 1991 to late 1992 (see Figure 1-4).

Besides affecting spending on investment and durable goods, lower interest rates reduce the existing debt burdens of many borrowers. But the refinancing of existing consumer and business debt may not have a large net effect on the economy. Although the millions of people who have refinanced more than $300 billion of their existing home mortgages over the past year now have some extra dollars to spend on goods and services, by contrast people who rely on the interest earnings from their savings now have less money to spend. Unless borrowers and savers spend these marginal changes in their income differently, the decreased consumption by savers could offset the increased consumption by borrowers.

Figure 1-4.
Consumer Installment Debt



SOURCES: Congressional Budget Office; Federal Reserve Board.

Low interest rates also help U.S. businesses by reducing the exchange rate of the U.S. dollar below what it otherwise would be, thus making U.S. goods and services cheaper relative to foreign-produced goods and services. Under most circumstances, the resulting improvement in net exports would be a major benefit of controlling the deficit. Because other factors dominate the outlook for net exports, however, this advantage will barely be noticeable over the next few years. The most important factor is the relative rates of growth between the United States and its trading partners. Even though growth is sluggish in the United States, it is still better than other large countries are likely to experience. This difference in respective growth rates implies some worsening of net exports.

Table 1-2.
The Fiscal Policy Outlook (By fiscal year, on a budget basis)

	1992	1993	1994	1995	1996	1997	1998
	In Billions of Dollars						
Deficit Excluding Deposit Insurance[a]	293	292	240	206	200	206	204
Standardized-employment deficit	200	211	175	154	160	180	186
Cyclical deficit	93	81	65	52	40	27	18
Effects of OBRA-93[b]	*0*	*0*	*-33*	*-55*	*-83*	*-118*	*-143*
Memorandum:							
Deposit Insurance	3	-26	14	-10	-10	-8	-4
Desert Storm Contributions	-5	0	0	0	0	0	0
	As a Percentage of Potential GDP						
Deficit Excluding Deposit Insurance[a]	4.8	4.6	3.6	2.9	2.7	2.7	2.5
Standardized-employment deficit	3.2	3.3	2.6	2.2	2.2	2.3	2.3
Cyclical deficit	1.5	1.3	1.0	0.7	0.5	0.4	0.2
Effects of OBRA-93[b]	*0*	*0*	*-0.5*	*-0.8*	*-1.1*	*-1.5*	*-1.8*

SOURCE: Congressional Budget Office.

a. The 1992 measure also excludes allied contributions for Operation Desert Storm.

b. The effects of OBRA-93 are included in the standardized-employment deficit reported in this table.

Deficit Reduction Will Dampen Growth in 1994

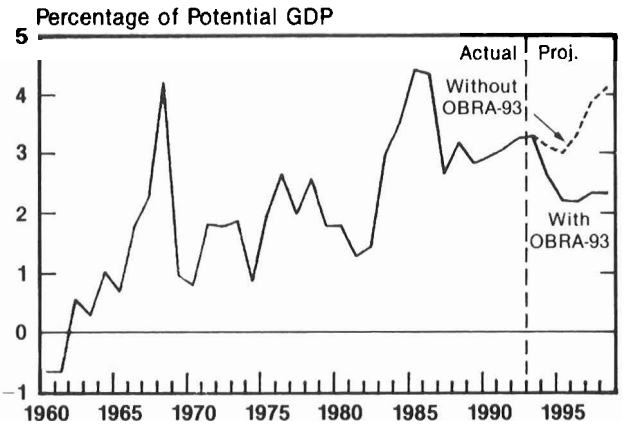
In the short run, the fiscal restraint slated for next year will tend to depress growth despite the drop in long-term interest rates. Deficit reduction, however, will ultimately lead to a higher level of GDP than what otherwise would have occurred. Smaller deficits will raise the national saving rate, permit more investment, and in the long run result in a higher level of output. But over the next three to five years, OBRA-93 may lower the average growth of output by about one-fourth of a percentage point, assuming that the Federal Reserve offsets some of the fiscal restraint.[2]

CBO measures the policy-related stimulus or restraint that the budget provides the economy by year-to-year changes in the standardized-employment deficit relative to potential GDP (the highest rate of output that available resources of capital and labor could sustain without increasing the rate of inflation). This measure differs from changes in the actual deficit by removing the outlays for deposit insurance and the cyclical effects of the economy on the budget.

After changing little from 1992 to 1993, the standardized-employment deficit is expected to decline substantially--by 0.7 percent of potential GDP--from 1993 to 1994, of which OBRA-93 accounts for 0.5 percentage points (see Table 1-2 and Figure 1-5). This pattern of fiscal impact, however, may overstate the restraint in 1994 and understate it in 1993. Most of the restraint in 1994 comes from the recently enacted tax increase on the wealthy, and some of these taxpayers may pay their higher taxes by reducing their saving rather

2. CBO has not prepared a forecast that excludes the effects of OBRA-93. This estimate relies on previous analysis in CBO's *The Economic and Budget Outlook: Fiscal Years 1994-1998* (January 1993) and "An Analysis of the President's February Budgetary Proposals," CBO Paper (March 1993).

Figure 1-5.
Effect of OBRA-93 on the Standardized-Employment Deficit (By fiscal year)



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

NOTE: OBRA-93 = Omnibus Budget Reconciliation Act of 1993.

than their consumption. Such behavior would soften the impact of fiscal restraint in 1994. At the same time, those who choose to pay their additional taxes by reducing their consumption may already have begun to do so, effectively shifting some fiscal restraint into 1993. A cutback in consumption may take place despite provisions that allow taxpayers to spread the payment of their increased 1993 tax liability over the next three years.

Fiscal policy will continue to restrain the economy in 1995, when the standardized-employment deficit declines by another 0.4 percent of potential GDP. During the 1996-1998 period, however, the overall stance of fiscal policy is essentially neutral, as the accumulation of spending reductions in OBRA-93 helps to keep the standardized-employment deficit from rising much relative to potential GDP. Without OBRA-93, the standardized-employment deficit would climb to 4.1 percent of potential GDP by 1998.

Enacting OBRA-93 should slow the growth of federal debt during the projection period. CBO now projects that the debt-to-GDP ratio will increase from 51 percent in 1992 to 55 percent in 1998. Without OBRA-93, CBO estimated the debt-to-GDP ratio would have increased to 58 percent in 1998.

State and Local Governments Will Not Provide Much Stimulus

Although lower long-term interest rates have helped state and local governments improve their financial condition, that help will not be enough to relieve them of the fiscal problems that have accumulated in recent years. Consequently, CBO does not expect spending by state and local governments to contribute significantly to overall growth in the economy. The demand for services provided by state and local governments--such as education, health, and public safety and infrastructure investment--continues to grow, but state and local revenues still lag, reflecting the slow growth throughout the economy. Moreover, these governments face pressures by citizens to hold down tax increases.

Until fairly recently, many states had exempted entitlement programs such as Medicaid and Aid to Families with Dependent Children (AFDC) from budget cuts. But this situation may be changing. For example, six states, among them California and Michigan, spent less on AFDC in their 1992 fiscal years than they had over the previous year. Even so, these programs will continue to press against limited resources and challenge state and local finances in the years ahead.

Monetary Policy Is Likely to Remain Cautious

Having taken its last easing action in September of 1992, the Federal Reserve announced in its recent report to the Congress that future

monetary policy would probably be tilted in the other direction.[3] It suggested that, with economic growth forecast to continue through 1994, it may need to let short-term rates of interest rise at some point, if the economy is to achieve its long-range objectives of low inflation and sustained growth of production. Even though CBO's forecast implies that the Federal Reserve will not face an inflation problem through 1994, the forecast assumes that short-term rates will rise gradually in line with Federal Reserve objectives as the gap between potential and actual GDP narrows.

Inflation Will Probably Not Pose a Short-Term Problem for Monetary Policy

With the outlook for moderate economic expansion, CBO's forecast implies little, if any, inflationary pressure. Measured by the CPI-U, inflation is forecast to be 3.4 percent in 1993 and 3.1 percent in 1994, about the same as the Federal Reserve forecast in its report to the Congress. The forecast rate in 1993, which is greater than the 3.1 percent rate of increase in 1992, reflects the temporary factors noted earlier as well as the hike in the federal gasoline tax. The rise in the gasoline tax causes a one-time increase in the CPI-U during the fourth quarter of 1993.

Traditional nonmonetary indicators that have been reliable gauges of inflationary pressures do not suggest that higher inflation lies ahead (see Figure 1-6). One such indicator is the GDP gap, the shortfall of GDP below potential GDP. It is a summary measure of the degree of excess capacity in the economy. When excess capacity dwindles, inflationary pressures can build. However, this indicator suggests that inflationary pressures will not appear through 1993 and 1994, since real GDP is expected to remain below the economy's potential level of output over this period.

A second indicator of inflation is unit labor costs in the nonfarm business sector. This indicator measures the contribution of labor compensation, the largest component of business costs, to the prices of goods and services. Unit labor costs have been rising at the rate of only 2 percent per year. Forecasts of unit labor costs, reflecting slowly improving labor markets and continued competition from abroad, also suggest that inflationary pressures will not increase through 1994.

Interest Rates Will Reflect the Federal Reserve's Long-Term Objectives

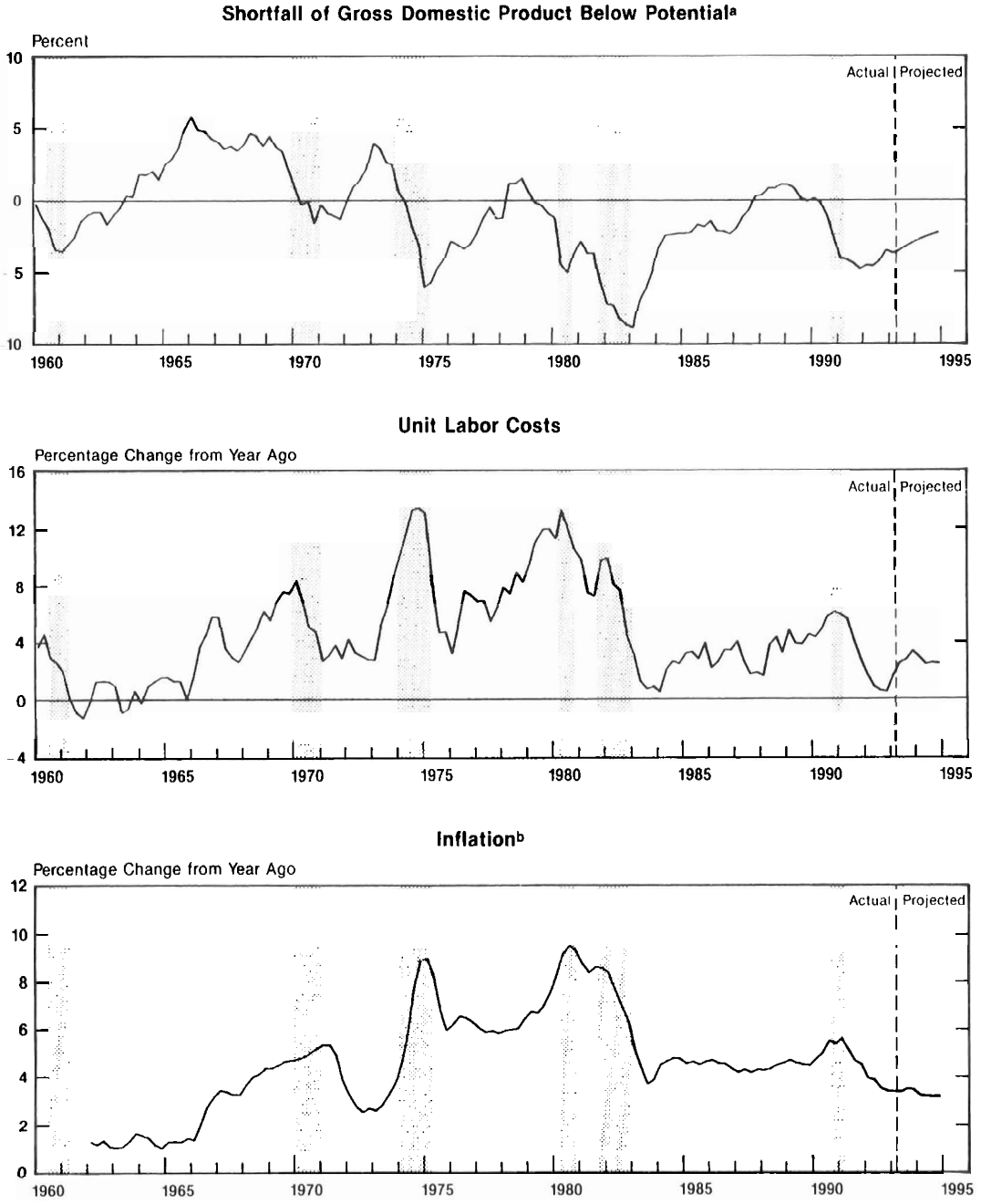
In its report to the Congress, the Federal Reserve focused its discussion about the stance of monetary policy on inflation-adjusted, or real, short-term interest rates, describing them as too low to assure continued expansion with low inflation. This focus reflects the increased difficulty in using the monetary aggregates as a guide for policy (see Box 1-1).

Over the last year, real short-term rates have been close to zero and occasionally negative. Historically, real short-term rates, when kept low for too long, have been associated with an unsustainable growth of real GDP and rising inflation. Even though increased inflationary pressures are not forecast through 1994, the Federal Reserve cited expectations of higher inflation, triggered by a temporary increase in inflation during the first half of 1993, as evidence that the markets have become concerned about higher inflation in the future.

To prevent the expansion from proceeding too rapidly and increasing inflationary pressures, the Federal Reserve said that it may eventually need to let short-term interest rates rise. Market expectations of a modest, future action by the Federal Reserve might then calm fears of increased inflation over the

3. Board of Governors of the Federal Reserve System, "Monetary Policy Report to the Congress Pursuant to the Full Employment and Balanced Growth Act of 1978" (July 20, 1993).

Figure 1-6.
Inflation Indicators and Inflation



SOURCES: Congressional Budget Office; Department of Labor, Bureau of Labor Statistics; Department of Commerce, Bureau of Economic Analysis.

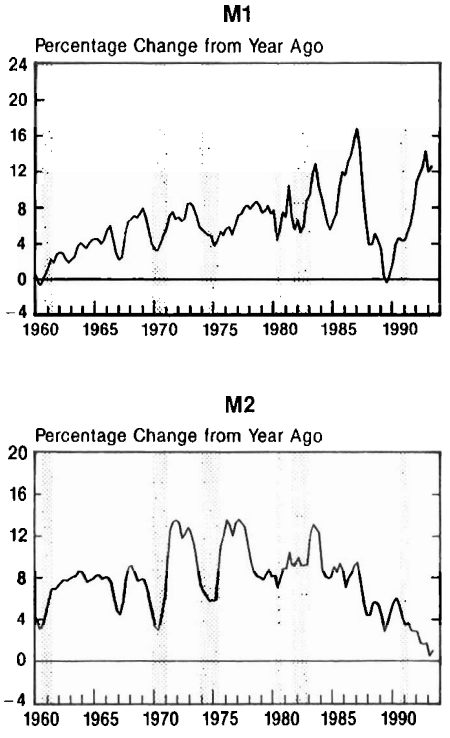
a. The shortfall is the difference between actual and potential real gross domestic product.

b. Consumer price index for all urban consumers (CPI-U), excluding food, energy, and used cars. The treatment of home ownership in the official CPI-U changes in 1983. The inflation series in the figure uses a consistent definition throughout.

Box 1-1.
Monetary Aggregates Shelved as Policy Gauges

Citing the unusually slow growth in the monetary aggregates M2 and M3 amid the last two years of economic recovery and expansion, the Federal Reserve, in its recent report to the Congress, chose to downplay the role of the aggregates in assessing the stance of monetary policy. M2, once the Federal Reserve's primary monetary aggregate, has grown at an average annual rate of 1.6 percent since the end of the recession, while M3 has grown only 0.1 percent. In contrast, M1--the aggregate once targeted but then abandoned by the Federal Reserve after 1986--averaged 11.5 percent growth (see figure).[1]

Monetary Aggregates



SOURCES: Congressional Budget Office; Federal Reserve Board.

The combination of slow growth in M2 and moderate though faster growth of the economy has pushed up the velocity of M2--the dollar amount of economic activity supported by each dollar of M2--to levels not seen since the early 1980s. Although such high levels of velocity initially seemed unsustainable to many analysts, the Federal Reserve now seems inclined to the view that they may persist for a longer time.[2] As a result, the Federal Reserve has not looked to the slow growth of M2 in judging the stance of monetary policy. Instead, inflation-adjusted interest rates seem to have taken M2's place.

Analysts now widely accept that the slow growth of M2 and M3 reflects slow growth of demand for loans by individuals and businesses, together with an unwillingness of banks and thrifts in some regions to make loans, and the need by many banks and thrifts to improve their balance sheets. Banks and thrifts have not actively sought additional deposits, as reflected in low rates offered to depositors. Resolving the insolvency problem in the thrift industry has also contributed to low rates on deposits. Consequently, some depositors, seeking higher returns, have moved their funds out of deposits in banks and thrifts and into bond and equity investments, lowering the growth of M2 and M3. Some analysts have even suggested that the definition of M2 be modified to include those mutual funds investing in bonds.

Although the reasons for slow growth of M2 have become better understood, what the slow growth means for the economy has been and still is controversial. Critics of the decision to downplay M2 have suggested that slow growth of M2 is contributing to slow economic growth. They call for a more stimulative monetary policy to offset the drag on economic growth stemming not only from the balance sheet problems in banks, thrifts, households, and business, but also from the impending tighter fiscal policy.

1. M1, M2, and M3 are measures of the U.S. money supply. M1 consists of the public's holdings of currency, traveler's checks, and checkable deposits. M2 is primarily M1 plus small (less than $100,000) time and savings accounts, money market deposit accounts held at depository institutions, and most money market mutual funds. M3 primarily consists of M2 plus large (more than $100,000) time deposits and money market mutual funds owned by institutions.

2. At mid-year the target ranges for M2 were reduced by 1 percentage point for 1993 to a range of 1 percent to 5 percent and to the same range for 1994 to reflect higher velocity. (For similar reasons, the ranges for M3 were reduced by one-half of a percentage point to 0 percent to 4 percent for 1993 and 1994.)

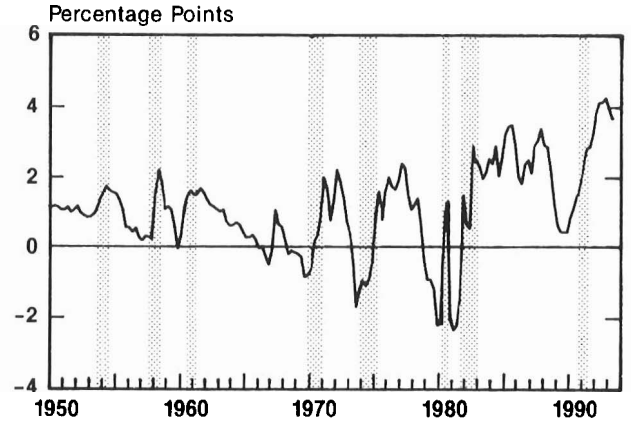
long run and help keep long-term rates of interest stable. Confidence in the Federal Reserve's commitment to low inflation probably helped the decline in long-term interest rates during 1991 and 1992.

The Federal Reserve's reliance on interest rates to gauge its own policy stance involves some risks. However, these risks are probably unavoidable. Interest rates move both because of policy changes and because of changes in the economy, and disentangling the two is extremely difficult. Thus, if interest rates rise, the Federal Reserve cannot be sure whether they are going up because of incipient inflationary pressures or simply because monetary policy is too tight.

The changed outlook for the deficit--which has cut long-term interest rates by an unknown amount--further complicates the Federal Reserve's task. The Federal Reserve could offset much of the effect of fiscal restriction by initiating an easier monetary policy than it would have pursued otherwise.[4] But the peak effects of monetary policy occur only after a significant lag, so choosing the appropriate policy depends on anticipating how much the deficit cuts will weaken the economy in the future. Too much ease would risk overheating the economy and increasing future inflation, though that risk currently seems remote. Too much restraint would hold back growth unnecessarily, though it would also help to wring out some of the remaining underlying inflation from the system.

CBO's forecast assumes that the Federal Reserve will continue to emphasize the importance of fighting inflation without unduly restricting growth. As a result, the Federal Reserve will most likely allow a modest increase in short-term rates of interest. With the expected increase, short-term rates would be roughly one-half of a percentage point above the forecast for inflation--that is, real short-term rates would rise to about one-half percent.

Figure 1-7.
Spread Between Long- and Short-Term Interest Rates



SOURCES: Congressional Budget Office; Federal Reserve Board.

NOTE: Composite Treasury bonds minus three-month Treasury bills.

The forecasts for long-term and short-term interest rates imply a decline in the unusually large spread that has existed between them during the last three years. The decline would be similar to that seen in the first half of the 1960s, when short-term rates rose modestly, long-term rates mostly stayed unchanged, and the spread narrowed (see Figure 1-7).

Net Exports Will Not Provide Any Stimulus

Although fiscal policy occupies center stage in reshaping the forecast for 1993 and 1994, the outlook for U.S. exports also plays a key role. CBO's winter forecast of foreign demand for U.S. exports in 1993 and 1994 was hardly sanguine, but even that forecast now appears to be optimistic. Forecasts of economic activity in regions that absorbed about one-third of U.S. exports last year have been scaled back for 1993 and 1994. But growth in other regions, along with the beneficial effects of defi-

4. See Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994-1998*, Chapter 5.

cit reduction, should prevent the export picture from being even more dismal.

In the European Community (EC), where the United States sold 23 percent of its merchandise exports in 1992, the outlook for growth has dimmed considerably since last winter. Economic forecasts for the EC in 1993 have been revised from the 0.7 percent growth predicted last winter to a contraction of 0.5 percent. That performance would be the worst in almost 20 years.

Growth for 1994 has been trimmed back to 1.2 percent, and unemployment in that year is expected to reach the highest rate since 1985. Among individual EC countries, the recession in Germany is deeper and the recovery is likely to be slower than was initially thought, and this view has correspondingly clouded the outlooks in other EC countries such as France, Italy, the Netherlands, Spain, and Belgium. Only the United Kingdom is expected to show modest growth this year and next.

By early August, the continuing downward revisions in forecasts of economic activity in Europe, combined with the Bundesbank's concern over Germany's rate of inflation, ignited a crisis in the European Monetary System (EMS). For much of the past year, most EC members have continued to follow the relatively tight monetary policy that Germany has pursued as it struggled with reunification. The similarity of monetary policies was necessary to maintain exchange rates within narrow bands prescribed by the exchange rate mechanism (ERM) of the EMS. In early August, however, a continuing gap between symptoms of inflationary pressures in Germany and high unemployment and low inflation in France made the existing parities among EMS currencies difficult to maintain.

Once the Bundesbank chose on July 29 to hold its discount rate at 6.75 percent, signaling the primacy of its anti-inflation objectives, the French, Danish, Spanish, Portuguese, and Belgian currencies all came under attack, and the European finance ministers opted to increase the width of their currency bands without changing the central parities. They hope that this tactic will ensure that the ERM will not collapse under market pressures.

European central banks now have the scope to relax their monetary policies. Nevertheless, so far they have eased only slightly. This limited action probably reflects their ongoing concerns about inflation and their continued ambitions for a European monetary union as set forth in the Maastricht treaty. The easing that has occurred may only serve to offset the unexpected weakness that led to the crisis.

Expectations for growth in Japan, which purchased 11 percent of U.S. merchandise exports last year, have been lowered. Forecasts for Japan prepared late last year envisioned 2.3 percent growth for 1993. Current forecasts are more gloomy and indicate only 1.5 percent growth.

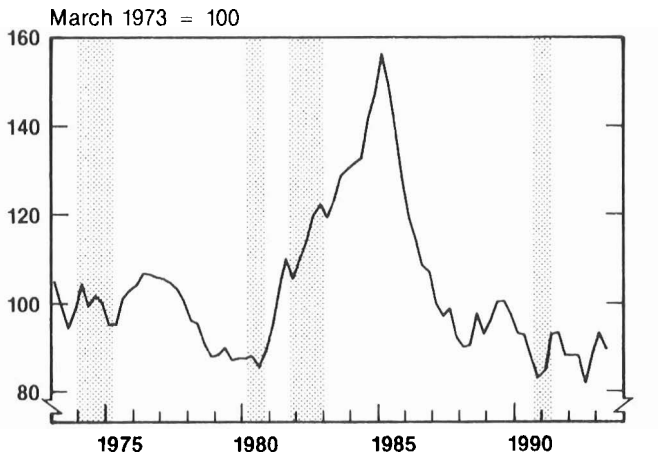
Elsewhere, however, the outlook for exports remains relatively bright. In Canada, the largest single market for U.S. exports (20 percent in 1992), expected growth for 1993 remains close to 3 percent. Demand for U.S. goods from Latin America and the newly industrializing countries of Asia should also remain high. Together, these two regions accounted for almost 30 percent of the value of U.S. merchandise exports last year, purchasing large amounts of capital goods in their drive toward industrialization.

The outlook for exports to Mexico could be darker if the North American Free Trade Agreement (NAFTA) is not ratified. Expectations of NAFTA's being adopted and the other economic reforms in Mexico have already contributed to a sharp increase in U.S. exports to Mexico. Future exports could be set back, at least temporarily, if NAFTA is not adopted.[5]

With relatively stronger growth in the United States than in many of its trading partners, U.S. imports are likely to grow more

5. The possible economic impacts of NAFTA are discussed in CBO's *A Budgetary and Economic Analysis of the North American Free Trade Agreement* (July 1993).

Figure 1-8.
The Exchange Rate



SOURCES: Congressional Budget Office; Federal Reserve Board.

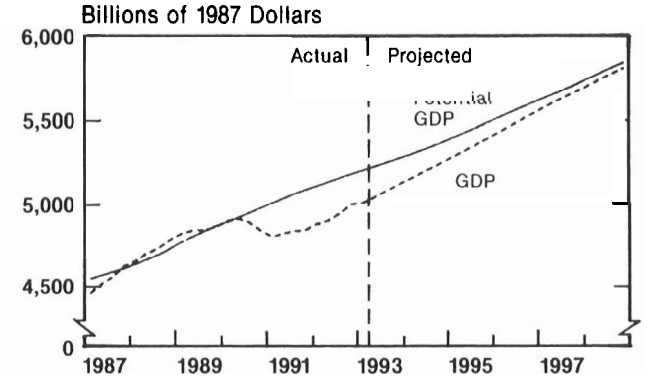
swiftly than exports. One component of domestic growth--the demand for investment--will be met, in part, by imports of capital goods. Although those imports add to domestic capacity just as if the capital goods were produced here, like all imports they weaken the stimulus to domestic demand that would occur if the goods were produced in the United States.

Unexpected movements in exchange rates since last winter do not affect the forecast much. True, the dollar has changed significantly in recent months against individual currencies, such as the Japanese yen and German mark. Yet it has changed little on a trade-weighted average basis, which includes the currencies of all the major trading partners of the United States (see Figure 1-8). Exchange rates are ultimately important to exports and imports, but over the forecast horizon the relative changes in economic activity exert a larger influence on the outlook for trade than do the recent exchange rate movements.

Projections Beyond 1994

From 1995 through 1998, CBO projects that real GDP growth will average 2.6 percent (see Tables 1-3 and 1-4). The medium-term projections for growth do not reflect any attempt to estimate cyclical movements of the economy or the effect of fiscal policy on the year-to-year changes in economic activity. The projections attempt to approximate the level of economic activity on average over those years, and incorporate the possibility of either above- or below-average growth. The GDP path is projected by first estimating the level of potential GDP in 1998 and then assuming that the actual level of GDP will trend upward so that the gap between actual and potential GDP will be equal to its historical average of 0.6 percent in 1998 (see Figure 1-9).

Figure 1-9.
Closing the Gap: GDP Versus Potential GDP



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Inflation, as measured by the consumer price index, is projected to average about 3 percent, and long-term interest rates about 6.1 percent. Short-term rates are assumed to move upward from 3.6 percent in 1994 to 4.6 percent in 1998, making the spread between long-term and short-term rates similar to its average over recent decades.

The Projection for Growth

CBO has revised its outlook for potential growth of the economy during the projection

Table 1-3.
Medium-Term Economic Projections for Calendar Years 1993 Through 1998

	Actual	Forecast		Projected			
	1992	1993	1994	1995	1996	1997	1998
Nominal GDP (Billions of dollars)	5,951	6,267	6,605	6,951	7,317	7,696	8,078
Nominal GDP (Percentage change)	4.8	5.3	5.4	5.2	5.3	5.2	5.0
Real GDP (Percentage change)	2.1	2.6	2.7	2.7	2.7	2.6	2.4
Implicit GDP Deflator (Percentage change)	2.6	2.6	2.6	2.5	2.5	2.5	2.5
Fixed-Weighted GDP Price Index (Percentage change)	2.9	3.2	2.9	2.7	2.7	2.7	2.7
CPI-U (Percentage change)	3.0	3.3	3.2	3.0	3.0	3.0	3.0
Unemployment Rate (Percent)	7.4	6.9	6.6	6.3	6.0	5.8	5.7
Three-Month Treasury Bill Rate (Percent)	3.4	3.1	3.6	4.1	4.5	4.6	4.6
Ten-Year Treasury Note Rate (Percent)	7.0	6.0	6.1	6.1	6.1	6.1	6.1
Tax Bases (Percentage of GDP)							
Corporate profits	6.6	7.3	7.3	7.1	7.0	6.9	6.8
Other taxable income	20.5	20.4	20.4	20.5	20.6	20.7	20.8
Wage and salary disbursements	49.0	48.9	49.0	49.1	49.0	49.0	48.9
Total	76.1	76.6	76.6	76.7	76.7	76.6	76.5

SOURCE: Congressional Budget Office.

NOTES: The data in the table do not incorporate either the advance estimate of second-quarter GDP released by the Bureau of Economic Analysis in late July or the effects of the regular annual revision to the national income and product accounts released by BEA in late August.

CPI-U is the consumer price index for all urban consumers.

period upward to 2.1 percent per year, a rate that is 0.1 percentage point faster than last winter's projection. In order to project potential output, CBO extrapolates trends in such fundamental economic variables as the labor force, the rate of national saving, and total factor productivity (TFP).[6] The upward revision reflects the influence of higher national saving that should result from deficit reduction, and from a slightly higher estimate of the rate of trend growth in TFP that results from previously unavailable data.

With smaller deficits than were projected last winter, the federal government will absorb a correspondingly smaller amount of national saving. As a result, more saving will be available to invest in private domestic plant and equipment--the primary basis for improving the level of GDP and living standards in the long run. In addition, with smaller deficits, less borrowing from abroad will be

6. Total factor productivity is a measure of the productivity of both labor and capital. A more comprehensive measure than labor productivity, it is defined as the growth in output above the growth in the capital and labor inputs.

Table 1-4.
Medium-Term Economic Projections for Fiscal Years 1993 Through 1998

	Actual	Forecast		Projected			
	1992	1993	1994	1995	1996	1997	1998
Nominal GDP (Billions of dollars)	5,869	6,189	6,522	6,862	7,224	7,601	7,984
Nominal GDP (Percentage change)	4.2	5.5	5.4	5.2	5.3	5.2	5.0
Real GDP (Percentage change)	1.3	2.8	2.6	2.7	2.7	2.7	2.5
Implicit GDP Deflator (Percentage change)	2.9	2.6	2.7	2.5	2.5	2.5	2.5
Fixed-Weighted GDP Price Index (Percentage change)	3.0	3.1	3.1	2.7	2.7	2.7	2.7
CPI-U (Percentage change)	3.0	3.2	3.2	3.0	3.0	3.0	3.0
Unemployment Rate (Percent)	7.3	7.1	6.6	6.3	6.1	5.9	5.7
Three-Month Treasury Bill Rate (Percent)	3.8	3.0	3.4	4.0	4.4	4.6	4.6
Ten-Year Treasury Note Rate (Percent)	7.2	6.2	6.1	6.1	6.1	6.1	6.1
Tax Bases (Percentage of GDP)							
Corporate profits	6.4	7.2	7.3	7.2	7.0	7.0	6.8
Other taxable income	20.6	20.5	20.4	20.5	20.6	20.7	20.8
Wage and salary disbursements	49.2	48.8	49.0	49.1	49.1	49.0	48.9
Total	76.2	76.5	76.6	76.7	76.7	76.6	76.5

SOURCE: Congressional Budget Office.

NOTES: The data in the table do not incorporate either the advance estimate of second-quarter GDP released by the Bureau of Economic Analysis in late July or the effects of the regular annual revision to the national income and product accounts released by BEA in late August.

CPI-U is the consumer price index for all urban consumers.

needed. And less borrowing, along with reduced flows of interest, dividends, and profits paid to foreign investors, will make the nation's income higher than otherwise.

In determining how the new fiscal policy in OBRA-93 affects growth and income, CBO adopts conservative assumptions about the responses of private saving and foreign borrowing to deficit reduction. National saving will not increase dollar for dollar with deficit reduction, since reductions in private saving will offset some of the improvement coming from the new policies. The higher taxes in OBRA-93 will come partly from reduced consumption and partly from reduced saving. Following a number of statistical studies, CBO assumes in its projections that reduced private saving will offset about 30 percent of the reduction in the deficit compared with the baseline before OBRA-93.

Saving from deficit reduction could also be spent on reducing net borrowing from abroad rather than on domestic investment. As a result, private domestic investment in plant,

equipment, and inventories would rise, but by much less than a dollar for every dollar's worth of deficit reduction.[7]

CBO projects that the productivity of labor, as measured by real GDP divided by total employment, will grow at an average annual rate of about 1 percent through 1998, or 0.1 percentage point higher than CBO assumed last winter. The increase stems from two sources: the beneficial effects of deficit reduction on the pace of capital accumulation, and a new estimate of the trend in growth in TFP. The new estimate results from additional information that has been released since the estimate for last winter was made.

The rate of growth of labor productivity is somewhat better than in the 1980s, when productivity grew at an annual rate of 0.7 percent. Some analysts have argued that the long-term trend in growth of productivity may take an even greater step up. They maintain that the better application of computers and the general restructuring of firms will improve the long-term trend. The recent pickup in the growth in productivity--averaging 1.2 percent over the last two years--seems to lend support to these arguments, but close analysis and recent revisions in the employment data suggest that cyclical factors largely account for the rebound (see Box 1-2).

The Projection for Inflation

CBO continues to project a low rate of inflation on average, which reflects sufficient excess capacity on average during the projection period. For 1995 through 1998, inflation is projected to average 3 percent as measured by the CPI-U, and the growth of the implicit deflator for GDP is projected to average 2.5 percent. These projections are each no more than 0.3 percentage points higher than the projections of last winter.

The Projection for Interest Rates

As for CBO's projections for interest rates, the rate on 10-year Treasury notes will average about 6.1 percent over the 1995-1998 period and the rate on three-month Treasury bills will average 4.4 percent. The projections for interest rates assume that inflation trends do not change and that the spread between long-term and short-term rates moves toward its historical average by 1998.

Higher real short-term rates account for the rise in nominal short-term rates from 3.6 percent at the end of the forecast period to 4.6 percent at the end of the projection period. CBO assumes that the inflation-adjusted short-term rate will rise from its forecasted level of 0.8 percent at the end of 1994 to the average historical level of 1.6 percent in 1998. The projection for inflation-adjusted rates is lower than that of last winter because of deficit reduction and the related improvement in net national saving.

What Other Forecasts Say

Both CBO's near-term forecast and the medium-term projection for real GDP growth are similar to those of the Administration and the *Blue Chip* consensus of forecasters.[8] However, important differences underlying the CBO and *Blue Chip* outlooks reflect inherent risks and uncertainties in the forecast. (Past forecasts of the Congressional Budget Office, the Administration, and the *Blue Chip* consensus are compared in Appendix A.)

7. For a discussion of these assumptions, see Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1994-1998*, Chapter 5.

8. See Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (August 10, 1993).

The Near-Term Forecast

CBO's forecasts for real GDP growth over the 1993 to 1994 period are virtually the same as those for the Administration and the *Blue Chip* consensus survey. The three forecasts for unemployment are also virtually identical (see Table 1-5).

Nevertheless, the CBO and *Blue Chip* forecasts differ in both years about the sources of growth. The consensus expects more stimulus

Box 1-2.
Is There a New Trend in the Growth of Productivity?

Some analysts speculate that the high growth rate of labor productivity (output per hour in nonfarm business) during the recovery heralds a new trend after more than two decades of disappointing growth. The Congressional Budget Office, however, considers the rebound to represent more a normal cyclical phenomenon than a harbinger of a new trend.

From the end of World War II through 1965, productivity grew at an average rate of 2.7 percent a year. Then growth slowed dramatically. Almost all of the slowing occurred in the nonmanufacturing sector, which is dominated by services. Since the oil shock of 1973, growth in productivity averaged 0.7 percent a year.

Productivity growth played an unusual role in the recent recovery, however. Productivity contributed much more--and growth in jobs much less--to the pace of the current recovery than was the case in previous postwar recoveries. Previously, eight quarters into the average recovery, productivity advances averaging 5.8 percent accounted for just over one-half of the average 10.3 percent growth in real gross domestic product (GDP) from the recession trough. In contrast, eight quarters into the current recovery, productivity growth accounted for virtually all of the 4.2 percent advance in real GDP from its trough.

Does the unusually prominent role of productivity growth during the current recovery reflect a shift in underlying trends that might be expected to continue? Analysts are divided in their assessments.

Many analysts present qualitative evidence for a shift in the trend of productivity growth. They suggest that computers will enable service industries to raise their productivity in response to deregulation and global competition. They claim that restructuring in services reflects a productivity payoff to that sector's investment in computers during the 1980s. They also argue that improvements in the quality of the labor force will add modestly to growth in productivity. They point out that the age and educational attainments of the labor force, quality of young entrants, and labor-force experience of women are all increasing.

However, the recent increases in productivity growth are likely to be temporary. The timing of the present rebound in productivity growth corresponds at least as well to a normal cyclical recovery as to the special circumstances mentioned above.[1] Productivity growth typically begins to slow or even decline a year or two before a business cycle peak. In the late phase of an economic expansion, many businesses overestimate the strength of future economic growth and tend to hire excessively. Once a recession begins, movements in productivity typically mirror changes in output, declining during the recession and rebounding in recovery. The current recovery differs from earlier ones in degree, not in type.

Such factors as the service sector's investment in computers, deregulation, intensified global competition, and increases in the quality of the labor force occurred throughout the 1980s and cannot explain the sudden jump in productivity now. Moreover, even if the rebound could be attributed to the service sector's reaping a dividend for its increasing computer intensity, that would result in a one-time jump in the level of productivity, not a long-term shift in the rate of productivity growth.

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1. Robert J. Gordon, "The Jobless Recovery: Does It Signal a New Era of Productivity-Led Growth?" *Brookings Papers on Economic Activity*, no. 1 (July 1993). This analysis used data that have since been revised, but the pattern of revisions suggests that they would not materially affect the results.

Table 1-5.
Comparison of Forecasts for 1993 and 1994

	Actual 1992	Forecast 1993	Forecast 1994
	Fourth Quarter to Fourth Quarter (Percentage change)		
Nominal GDP			
CBO	5.7	5.2	5.2
Blue Chip	5.7	5.1	5.9
Administration	5.7	5.1	6.0
Real GDP[a]			
CBO	3.1	2.3	2.7
Blue Chip	3.1	2.2	2.7
Administration	3.1	2.0	3.0
Implicit GDP Deflator			
CBO	2.5	2.8	2.5
Blue Chip	2.5	2.9	3.1
Administration	2.5	2.9	2.9
Consumer Price Index[b]			
CBO	3.1	3.4	3.1
Blue Chip	3.1	3.3	3.4
Administration	3.1	3.3	3.3
	Calendar Year Averages (Percent)		
Civilian Unemployment Rate			
CBO	7.4	6.9	6.6
Blue Chip	7.4	6.9	6.6
Administration	7.4	6.9	6.5
Three-Month Treasury Bill Rate			
CBO	3.4	3.1	3.6
Blue Chip	3.4	3.1	3.6
Administration	3.4	3.1	3.6
Ten-Year Treasury Note Rate			
CBO	7.0	6.0	6.1
Blue Chip[c]	7.0	6.1	6.3
Administration	7.0	6.0	5.9

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (August 10, 1993); Office of Management and Budget.

NOTE: The CBO forecast does not incorporate either the advance estimate of second-quarter GDP released by the Bureau of Economic Analysis in late July or the effects of the regular annual revision to the national income and product accounts released by BEA in late August. The *Blue Chip* forecasts through 1994 are based on a survey of about 50 private forecasters.

a. **Based on constant 1987 dollars.**

b. The consumer price index for all urban consumers (CPI-U).

c. *Blue Chip* does not project a 10-year note rate. The values shown here for the 10-year note rate are based on the *Blue Chip* projections of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

from net exports and less stimulus from private domestic investment than does CBO. Not surprisingly, these components of aggregate demand are difficult to forecast, and the unsettled nature of domestic and foreign economies is undoubtedly reflected in the different outlooks for investment and net exports of the two forecasts.

Whereas the forecasts for the growth of GDP and the rate of unemployment differ little, the difference in the forecasts for inflation for 1994 is larger. The consensus expects inflation to rise in 1994, while CBO expects lower inflation and the Administration expects no change in the inflation rate. The consensus forecast for long-term interest rates is also slightly higher than CBO's and the Administration's forecasts, even though the forecasts for short-term interest rates are the same.

The Medium-Term Projection

With the exception of inflation, CBO's projections tend to lie between the *Blue Chip* and the Administration's projections. CBO's projection for real growth for 1995 through 1998 is sightly above the *Blue Chip* consensus projection and slightly below the Administration's (see Table 1-6). Correspondingly, CBO's projection for the unemployment rate tends to be below the *Blue Chip* projection and above the Administration's. CBO's projection for the three-month Treasury bill rate is also less than the *Blue Chip* projection but more than the Administration's, though the forecasts are very similar by 1998. By contrast, CBO's projection for the inflation rate is considerably below both the *Blue Chip* and the Administration's projections.

Table 1-6.
Comparison of Projections for 1995 Through 1998

	1995	1996	1997	1998
Percentage Change (Year over year)				
Real GDP[a]				
CBO	2.7	2.7	2.6	2.4
Blue Chip	2.8	2.6	2.3	2.5
Administration	2.8	2.7	2.6	2.6
CPI-U[b]				
CBO	3.0	3.0	3.0	3.0
Blue Chip	3.7	3.8	3.7	3.6
Administration	3.4	3.5	3.5	3.5
Calendar Year Averages (Percent)				
Civilian Unemployment Rate				
CBO	6.3	6.0	5.8	5.7
Blue Chip	6.2	6.1	6.1	6.0
Administration	6.1	5.9	5.7	5.5
Three-Month Treasury Bill Rate				
CBO	4.1	4.5	4.6	4.6
Blue Chip	4.7	4.9	4.9	4.7
Administration	3.9	4.2	4.5	4.5

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (March 1993); Office of Management and Budget.

a. Based on constant 1987 dollars.

b. Consumer price index for all urban consumers.